

# Pre-tax Voluntary Contributions: Legal Issues

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# Overview

- Indiana Code
  - Post-tax and Pre-tax 10% Voluntary Contributions
- Federal Tax Law
  - What is a “pick-up”?
- Employer Resolution to Participate
- Indiana Administrative Code/ PERF Board Policy
- Taxation
- Interaction with other retirement plans

# Indiana Statute

- IC 5-10.2-3-2

(c) A member of a fund may make contributions to the member's annuity savings account in addition to the [3% mandatory contributions]. The total amount of contributions that may be made to a member's annuity savings account with respect to a payroll period under this subsection may not exceed ten percent (10%) of the member's compensation for that payroll period. The contributions made under this subsection may be picked-up and paid by an employer as provided in subsection (d).

- (d) In compliance with rules adopted by each board, an employer, under Section 414(h)(2) of the Internal Revenue Code, may pick-up and pay the contributions under subsection (c), subject to approval of the board and to the board's receipt of a favorable private letter ruling from the Internal Revenue Service. The employer shall reduce the member's compensation by an amount equal to the amount of the member's contributions under subsection (c) that are picked-up by the employer. Each board shall by rule establish the procedural requirements for employers to carry out the pick-up in compliance with Section 414(h)(2) of the Internal Revenue Code.

# Federal Tax Law: What is a Pick Up?

- Contributions to a governmental tax-qualified retirement plan that are “picked up” by the employer “shall be **treated as employer contributions**” (26 U.S.C. 414(h)(2)).



# What makes it a pick up?

- The key criteria are in federal tax rulings (Rev. Rul. 81-35 and Rev. Rul. 81-36).
  - The employee must not have the option to choose to receive the contributions directly instead of having them paid to the plan.
  - Employer must specify that the contributions, which were designated as employee contributions, are being paid to PERF by the employer “in lieu of” contributions by the employee.
  - A pick up cannot be entered in to retroactively – the employer must have taken all necessary action to cause the contributions to be picked up.

# Why Pick Up?

- Because they are treated “as if” they are employer contributions, picked up contributions are not taxable income to the employee when the contribution is made, so taxes are deferred until the distribution from the retirement plan.

# Who pays for a “pick up” contribution?

- Could be employer or employee.
  - In cases you are familiar with, the 3% Mandatory Contributions are picked up and paid by the employer. For example, the State of Indiana for State employees. IC 5-10.3-7-9.
  - Some local employers have picked up some or all of the 3% mandatory contributions for their employees.

# Who pays for the voluntary pre-tax “pick up” contributions?

- State Law provides that the pre-tax voluntary contributions are paid by employee salary reduction contributions.
- IC 5-10.2-3-2(d) In compliance with rules adopted by each board, an employer, under Section 414(h)(2) of the Internal Revenue Code, may pick-up and pay the contributions under subsection (c), subject to approval of the board and to the board's receipt of a favorable private letter ruling from the Internal Revenue Service. **The employer shall reduce the member's compensation by an amount equal to the amount of the member's contributions under subsection (c) that are picked-up by the employer.** Each board shall by rule establish the procedural requirements for employers to carry out the pick-up in compliance with Section 414(h)(2) of the Internal Revenue Code.



# Does this mean there must be an increase in salary for employees?

- No. State law requires that employer reduce the employee's compensation by the amount of the pre-tax voluntary contributions elected by the employee.

# Can an employer enter into this program with its own resolution?

- No. The IRS requires PERF to use the IRS-required language to make the contributions non-taxable.

# PERF Model Resolution matches these federal tax rulings.

- **NOW, THEREFORE, BE IT RESOLVED**, that effective as of \_\_\_\_\_, the Employer desires to pick up all of the additional employee contributions made by employees through a binding irrevocable payroll deduction authorization. No additional employee contributions prior to the Employer's adoption of this Resolution shall be picked-up;
- **BE IT FURTHER RESOLVED**, that said additional employee contributions for state law purposes, are being paid by the Employer in lieu of said contributions by the employee;
- **BE IT FURTHER RESOLVED**, that the Employer shall comply with all of the terms and provisions of the Pick-Up Regulation and applicable provisions of the Internal Revenue Code.

# Revised Resolution to Clarify Employee Salary Reduction

- **NOW, THEREFORE, BE IT RESOLVED**, that effective as of \_\_\_\_\_, the Employer desires to pick up all of the additional employee contributions made by employees through a binding irrevocable payroll deduction authorization. No additional employee contributions prior to the Employer's adoption of this Resolution shall be picked-up;
- **BE IT FURTHER RESOLVED**, that said additional employee contributions, even though designated as employee contributions for state law purposes and withheld from pay under the terms of the Pick-Up Regulation and IC 5-10.2-3-2, are being paid by the Employer in lieu of said contributions by the employee;
- **BE IT FURTHER RESOLVED**, that the Employer shall comply with all of the terms and provisions of the Pick-Up Regulation and applicable provisions of the Internal Revenue Code.



# Pick Up Regulation

- Published as Proposed Rule in August 1, 2003 Indiana Register.
- Adopted as a binding PERF policy by Board pursuant to its statutory authority.

# Taxation

- No income tax withholding on pre-tax voluntary contributions when they are sent to PERF, and these amounts are not reported as taxable income on W-2.
- However, FICA applies to the pre-tax voluntary contributions.

# Interaction with 403(b) and 457 plans

- Members with 403(b) and 457 plan can continue to make maximum contributions to those plans, and participate in the voluntary pre-tax program.

# What limits apply to pre-tax voluntary contributions?

- For July 1, 2003 – June 30, 2004, qualified retirement plans (such as PERF) cannot take into account more than \$200,000 in compensation for any purpose (or \$300,000 for certain “grandfathered” members).
- Effectively limits voluntary pre-tax contributions to \$20,000 ( $10\% \times \$200,000$ )



# Limits on pension benefits

- Code Section 415 applies to limit overall retirement benefit attributable to employer contributions and pickups to \$160,000/year (single life annuity).
- \$160,000 is age-adjusted.